YOUR SECURITIES ACCOUNT

A guide for beginning investors

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Robin Carnahan
Secretary of State**

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This booklet is designed for the beginning investor. It briefly describes how a security transaction occurs, what to be aware of after the transaction is effected, and what to do if a discrepancy occurs in your account.

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Ordering the security

When you place an order, your agent fills out a form called an "order ticket" which records essential information about the order, such as the security symbol, your account number and the number of shares. The order ticket is taken to a wire operator who transmits the order to the firm's trader. A "fill" will usually occur within a few minutes. After the order is filled, a wire notice is sent back to your agent, notifying him or her that the transaction has been effected. A trade confirmation will be generated at the end of the day and mailed to you to notify you of your obligation to make payment or deliver marketable securities on or before the "settlement" date. The settlement date is three business days after the "trade date." This means that when you buy securities, your payment must be received by your brokerage firm no later than three business days after the trade is executed. And if you sell securities, your brokerage firm must receive your securities certificate no later than three business days after you authorize the sale.

Types of orders

In a normal securities transaction, you will place an order with your stockbroker to be filled at the present **market** price. However, there may be instances when buying or selling now at the market will not be appropriate, and you will want to enter a different kind of order. An **open order** is a standing order you leave with your broker to fill when the price of the security reaches a certain point. A **limit order** is used when you will not pay more than a certain amount or sell for less. A **stop order** is an order that becomes a market order when the market reaches a certain price. For example, if you wanted to limit your loss to $2.00 per share on the shares you bought for $10.00, you would put in a stop order at $8.00. As soon as the market reached $8.00, your broker would put in an order to sell **at the market.** If the market were moving very quickly, then your loss might be greater than $2.00. If the market bounced back from an $8.00 low, your loss might be less.

Broker-dealers and others

There are different kinds of broker-dealers, each performing different levels of service. An **exchange member firm** takes your order to the exchange to have it effected and will generally handle virtually every aspect of the transaction. An **introducing** broker-dealer (some times called a **fully disclosed** broker-dealer) acts only in a sales capacity and turns your order over to a **clearing** broker-dealer to be effected. The clearing broker places the order, generates the confirmation and handles the payment. Securities and funds are not held by the introducing broker but by the clearing broker.

Transfer agents are not broker-dealers under Missouri law, but do play an important part in the transaction. A transfer agent keeps track of the owners of the securities of a given company and is responsible for issuing your share certificate in your name, if you choose to hold the shares yourself. If you hold your securities in "street name" at your broker-dealer, the transfer agent's records will show the broker-dealer as the owner, and the broker-dealer's records will reflect that a certain number of the shares it holds belong to you. (Street name is especially good for someone who trades with any frequency, as it makes delivery by settlement date much easier).

Broker-dealers compensation

Broker-dealers are paid for their participation in the securities transaction in one of two ways. A broker-dealer is paid a commission when it arranges a trade between you and a third party (an *agency transaction*). There is usually a fixed minimum commission and then a percentage of the trade that decreases as the size of the trade increases. This amount will be deducted from your proceeds in a sale or added to your bill in a purchase.

Sometimes the broker-dealer does not arrange the trade with a third party, but actually is the other party (a *principal transaction)*. In this case, the broker-dealer does not charge a commission, but makes its money on the "spread". The spread is the difference between the "bid" and the "ask", or the price at which you could sell and at which you could buy, respectively. In most securities transactions, the spread is so small that there is little difference to you whether the transaction is agency or principal, but in some transactions, especially penny stock transactions, the spread can be huge and can result in significant losses to the investor. If your trade was a principal trade, your confirmation will say so.

Trade confirmations and monthly statements

Trade confirmations are a source of significant information about your trade and should be reviewed carefully **immediately** upon receipt. Always check to make certain that the transaction was what you ordered. Your stockbroker is only human and could either make a mistake or misunderstand what you wanted, or you could have miscommunicated your order. The confirmation will indicate whether your broker-dealer "makes a market" in the security you purchased, a fact really relevant only in penny stock transactions. (Another booklet in this series, *Penny Stocks,* explains market making in more detail.)

The confirmation will state the amount of commission charged on the transaction and whether the transaction was agency or principal. No commission will show on principal transactions and on certain other transactions, particularly bonds and mutual funds. It is important to keep in mind that, no matter how it shows on the confirmation, your broker-dealer is compensated in some fashion and you have the right to know about it.

Always check your monthly statement to be sure that all of the securities you have at your broker-dealer are shown on your monthly statement. As with trade confirmations, discrepancies should be immediately brought to your broker's attention. If you have difficulty reading or understanding your statements, arrange an appointment with your broker to go over them with you. Keep in mind that only securities held at your broker-dealer will show on your monthly statement.

Margin

Margin is the extension of credit to the investor by the broker-dealer to be used for securities transactions. To open a margin account, you deposit cash or negotiable securities as a partial payment or pledge for the securities purchased or to be purchased by the broker on your behalf. You sign a margin agreement that sets forth your obligations to pay in general and meet "margin calls", and gives the broker-dealer the right to pledge the securities held in your margin account as collateral for bank loans and to liquidate your securities positions if you fail to meet the margin calls on time. The margin agreement also contains a clause whereby you and broker-dealer agree that all disputes concerning the account will be taken to arbitration **and not to court.**

If the equity (the percentage of the market price of your securities that you have paid for) in your account falls below the minimum amount required by the firm or by an exchange (this happens because the market price falls) then you will receive a "margin call" that requires you to deposit money or additional securities into your account to bring it back up to the minimum.

Stock splits

Stock splits are where a share is split up into a larger number of shares. Reverse splits are where a number of shares are combined to form a smaller amount of shares. If, in a reverse split, the split will result in a fractional share, the value of that fractional interest will normally be paid in cash to the investor. In general, the price of the shares is adjusted so that the total value of the shares you owned before the split will be the same as the total value after the split. The usual reason for splits is to increase or decrease the par value of the stock. As splits do not have much effect on the actual value of your investment, the only real importance is to be aware of the actual number of shares you hold in case you want to sell, or in case dividends per share are distributed.

Dividends

Dividends are payments designated by the board of directors of a corporation to be distributed to the shareholders on a per-share basis. The dividend amount for preferred shares is usually a fixed amount but for common stock varies with the performance of the company. The decision to pay a dividend depends on the cash on hand, expansion plans, savings plans and how well the business is doing.

If the dividend on the preferred stock is cumulative, and the fixed amount has not been paid as it should have been, it will have to be paid before any common stock dividend can be paid. Non-cumulative dividends are more common. If a dividend is not paid in a particular year or period, there is no obligation to make up that payment before common stock divdends can be paid.

Record date

Dividends and splits occur as of a specific date called the **record** date, a date declared by the company, sometimes without notice to you but often on a set annual or semianual date. If you own the stock on the record date, then you are entitled to the dividend or the additional shares from the split. The record date concept is important if you buy or sell shares near the record date, because it makes settlement confusing. For example, if you sold your 100 shares the day before a 2-for-1 split, the trade would not settle until after the record date. You would tender your 100 shares and then, because you still held but did not actually own 100 shares on the record date, you would get another 100 shares issued to you. These are not yours to keep, of course, since you were paid the full pre-split price for your 100 shares. When dividends are issued near the trade date, there is usually a discount or premium on the trade to compensate the party that will not receive the dividend.

Bond calls

Most bonds have a feature that gives the issuer the option to **call** the bond at any time. This means that if you buy a bond that pays 15% interest and interest rates fall, the company that issued the bonds can state that it is buying back your bonds and will not pay any interest after the call date, so that it can reissue the bonds at a lower interest rate. The company only pays the principal amount plus any interest that accrued **by the call date**. The company is not liable for payment of additional interest after the call date. This rule prevents bondholders from delaying cashing in the bonds so as to stay at the higher rate of interest as long as possible. However, the company is not required to notify bondholders of the call individually, but only to advertise with public notices in certain financial publications. The bonds are generally called the day after an interest payment, and investors are usually not aware that the bonds were called until the next interest payment is due.

Options

An option is the right, but not the obligation, to purchase a security at a particular price, called the **strike price**. When you buy or sell an option, you are essentially betting that the market will move a certain way, and you are locking in a price at which you can buy or sell a certain quantity of securities, at a fixed price, within a certain period of time. A **call option** gives the buyer the right to purchase the underlying securities at the strike price on or before the expiration date. A **put option** gives the buyer the right to sell. Both put and call options can be either naked or covered. The **covered option** seller owns the actual securities underlying the option. A **naked option** is written without the securities as protection in the seller's account.

You buy a put when you believe that the price will decrease and a call when you believe that the price will increase. You sell the same option if you believe the opposite (that is, you sell a put if you think the price will increase, etc.). If you buy the option, your risk is limited to the premium you pay for the option. If the price does not reach the strike price by the expiration date, then the option will expire worthless and you will not exercise it. Your loss will be the loss of the premium you paid for the option, and the seller's gain will be the money you paid.

If however, the price went beyond the strike price, then you would exercise your option. If you bought a call and the price rose above the strike price, you would buy the securities at the option price (which is now lower than the market price) from the party that sold you the option. If the seller was covered, then they would sell you the securities out of their account. If the seller was naked, then they would have to go into the market and purchase the securities at the higher market price to sell to you at the lower option price.

As you can see from this example, the risk associated with option transactions varies greatly with each type. Option buyers' risk is limited to the amount they pay for the option. In a covered call, the seller's risk is limited to the price appreciation they **might have** gotten on the securities they already own. In a naked sale, the risk is theoretically unlimited.

Covered call writing (selling) can allow you to generate a greater return on the securities you hold by receiving the premiums people will pay for the option to buy your securities at a certain price. **There is always risk,** and there is a risk that the purchaser may exercise the option and "call" away your shares. You must decide whether the money that will be generated is worth the risk of having to sell your shares at a certain price. Naked option writing is **not appropriate** for the beginning investor.

Arbitration Arbitration is a way of resolving a dispute by impartial persons who know about the areas of controversy. Arbitration of securities cases has proven to be a quicker and less expensive way to resolve disputes than lawsuits. Arbitration decisions are final. That is, the decision can be reviewed by a court only on a very limited basis. The arbitration proceeding must be initiated within 6 years or within the time required by state or federal statutes of limitation, whichever is shorter.

In an arbitration proceeding, you are not required to have an attorney, but may have one if you wish. There are usually three arbitrators, the majority of which are not affiliated with the securities industry. The arbitrators do not give a written opinion explaining their decision the way courts do, so you will not be given a reason for the decision. Although this can be unnerving to the losing party, the lack of written opinions is one of the big factors contributing to the efficiency of the arbitration system. The biggest practical difference between arbitration and the courts is that arbitrators sit in equity. That means that they resolve the dispute on what seems to them to be fair, based on the standards of practice of the investment community, the expectations of the parties when the securities transactions were made, and on common sense.

Services of Missouri Division of Securities

The Missouri Securities Division is a division of the Office of the Secretary of State. The Securities Division registers securities and licenses the individuals who sell them. The staff of the Division is available to answer questions, receive complaints or check licenses and disciplinary history between the hours of 8:00 a.m. and 5:00 p.m. The office is located in Room 229 of the James C. Kirkpatrick State Information Center in Jefferson City.

Inquiries about securities registration:
(573) 751-4136

Inquiries about salesperson licenses:
(573) 751-2061

Complaints and questions:
(573) 751-4704

Toll-free hotline:
(800) 721-7996

Missouri Securities Division
Office of the Secretary of State
James C. Kirkpatrick State Information Center
PO Box 1276
Jefferson City, MO 65102-1276